AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

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U.S. stocks posted another positive showing in the third quarter, with a 1.1% gain as measured by the S&P 500. International developed and emerging markets were down 5.8% and 3.4% during the quarter,[1] though, and U.S. stocks finished the period trending lower. Market volatility remains relatively subdued but has picked up from recent lows. The bond market was essentially flat for the quarter.[2] For the year, U.S stocks are up 8.3%, bonds are up 2.1%, while international developed and emerging markets are down 0.9% and up 3.4%, respectively.

Notwithstanding the occasional pause, most notably during the debt ceiling debate in the fall of 2011, domestic stocks have steadily marched upwards for the past 5+ years. Some investors fret that markets have gone too far and stocks are overpriced. As we've explained in past missives, while we don't think stocks are cheap, we don't believe they are too expensive given the low level of interest rates. If the plodding economic recovery continues and interest rates don't markedly rise, both of which we see as entirely plausible, current stock prices don't appear irrational. Of course a big jump in interest rates or deterioration in record-high corporate profit margins could upset the apple cart. While we think these events are real possibilities, we don't see them as predestined outcomes, at least in the short to intermediate-term. Trying to jump in and out of the stock market is often a fool's game, and compelling evidence should accompany any fundamental shifts in stock exposure for long-term investors.

Yet calm stock markets and elevated stock prices can belie more turbulent undercurrents which may provide opportunities for patient investors. The S&P 500 index is a broad measure of stock prices for 500 of the largest corporations in America. The index's constituents are weighted according to their size. Apple, for instance, is the largest stock in the index at 3.4% while Zimmer Holdings, a much smaller (though still large) medical device company headquartered in Warsaw, IN, accounts for just 0.1% of the index. The S&P 500 index peaked on September 18th and is down just 2% since then. Within the index, however, individual constituents experience widely varying outcomes. In fact, nearly 10% of the stocks in the S&P 500 are down 20% or more from their 52-week high.

Think about that – approximately one out of every ten companies in the S&P 500 is valued today more than one-fifth less than they were valued at some point in the previous year. That's a big move! Imagine your business or your residence decreasing in value by 20% or more within a year.

[1] As measured by the relevant MSCI international indexes.
[2] As measured by the Citigroup 1-10 year Treasury index.

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For the most part, these companies have "fallen out of bed" because investors learned important new information about them. Perhaps they lost a big contract, reduced their long-term earnings targets or became the subject of problematic litigation. The associated price declines are likely rational – investors have surveyed the new information and appropriately revalued the companies to reflect the new reality. In a select number of cases, however, the stock price of a company declines for reasons unrelated to its long-term intrinsic worth.

These are the stocks we focus particular effort on, as do our investment partners. So even though the broader stock market is near all-time highs, we purchased two new stock positions in the past quarter that were down 20-30% this year (neither are part of the S&P 500). Success in these investments is by no means guaranteed, but our purchases reveal our belief that the market "got it wrong" in these instances. In each case, we employed our rigorous but simple two-step approach: first, develop a thesis for why the market is mispricing the stock and second, make sure the stock meets all of our investment criteria. This criteria is built on avoiding major risks – business obsolescence, excessive leverage, operational hazards, mismanagement, and overpaying for the company.

On the whole, we feel there aren't too many "pockets of opportunities" in today's investment markets. Most assets look efficiently priced to us. But the undercurrents of the last few months have served up more potential ideas than we've seen in a while. That being said, we kick a lot of tires but rarely pull the trigger. Most stocks that we or our investment partners research may look mispriced at first glance but are either cheap for a reason or subject to risks that we simply can't get comfortable with. Still, more ideas to research are a welcome development.

It is always important to stress that we don't know where markets will go from here and we don't believe anyone else does either. We try to work with clients to make sure they are comfortable with the amount of stock exposure they have in their portfolio. If you think that a stock market sell-off of 20% or more would be too much for you to bear, please contact us to review your current asset allocation. For those investors comfortable with their long-term investment policies, we reiterate our view – now is neither the time to dial up risk or to necessarily dial it back.

As always, we thank you for your continued confidence.

Sincerely,

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